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2017 BOSTON INVESTMENT MANAGEMENT CONFERENCE

Global Regulatory Update

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AGENDA

- MiFID II
- Brexit's Impact on Managers

MIFID II

INTRODUCTION

- The revised EU Markets in Financial Instruments Directive & Regulation
- A comprehensive re-imagining of existing legislation
- Apparently, 1.5 million paragraphs of regulations and over 70,000 pages
- London Evening Standard 17 October 2017
  - “City still is not ready for MiFID’s rules storm”
  - “biggest regulatory upheaval most…[firms]…will have seen in their lifetimes”
- 3 January 2018 effective date

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SCOPE OF MIFID II

- Not always easy to answer
- Directly, EU-based MiFID II-licensed firms (who may of course have U.S. affiliates or counterparties)
  - asset managers (<u>separate accounts</u>)
  - distributors (incl. tied agents)
  - brokers
  - banks
  - market operators
  - principal trading firms
- <u>Not</u> managers of investment funds (AIFMs & UCITS management companies) in relation to fund management

SCOPE OF MIFID II

- In the UK, MiFID II rules on payment for research, best execution, telephone taping and product governance applied to UCITS managers and (except best execution) AIFMs
- Important indirect impacts outside the EU:
  - sub-advisers of MiFID II firms may be expected to achieve comparable compliance
  - facilitating compliant reporting by EU counterparty
  - Trades on EU venues or with or through MiFID-licensed counterparties require Legal Entity Identifiers (LEI) and perhaps certain other details for transaction reporting.
  - sub-advisers of EU AIFMs & UCITS management companies

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INDUCEMENTS AND PAYMENTS FOR RESEARCH

- Most controversial aspect of MiFID II
- Pay out-of-pocket or Research Payment Account
- RPAs via accounting or CSA “enhancements”
- RPAs pose challenges
  - Valuing research
  - Allocating research costs amongst funds
  - Board / investor approval
  - Maintenance and administration
  - Different forms of “research”

INTERACTION OF MIFID II WITH U.S. LAW

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INDUCEMENTS, RPAS, AND SECTION 28(E)

- Section 28(e) provides a safe harbor from claims that a manager has breached its fiduciary duty:
  - Paying more than the lowest available **commission** for eligible research and brokerage services
  - Using research for the benefit of other clients for whom the manager exercises investment discretion
- Payments from RPAs are not “commissions”
  - But the economics of RPAs are largely indistinguishable from CSAs/CCAs, which are consistent with the Section 28(e) safe harbor

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DIRECT PAYMENTS FOR RESEARCH

- Advisers Act definition of an "investment adviser“
  - Any person who, for compensation, engages in the business of providing advice about securities
  - Presently, research is considered "solely incidental" to a broker-dealer’s business because brokers are compensated through brokerage commissions
- Under MiFID II, research must be paid for either through RPAs or out of the manager’s P&L
  - Neither represents traditional “commissions”

TRADE AGGREGATION AND ALLOCATION

- Aggregation of trades may violate Section 17(d) of the ICA and Section 206 of the IAA
  - SEC guidance permits managers to aggregate trade orders, provided that each participating clients receives the same average price and transaction costs are shared *pro rata*
- US manager engages in a block trade for in-scope and out-of-scope clients
  - Can the research component of commissions be allocated solely to out-of-scope clients?

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CUSTODY OF RPAS

- Rule 206(4)-2 and Section 17(f) of the ICA impose onerous obligations on managers with “custody” of client assets
- EU guidance: RPAs are not client funds
- However:
  - RPAs funds are sourced from client brokerage and must be spent on research for the benefit of the client
  - Unspent balances must be returned to clients
  - SEC staff has an expansive view of constructive custody

SEC NO-ACTION RELIEF

- SEC staff released 3 no-action letters to facilitate cross-border implementation of MiFID II's research provisions
  - SIFMA AMG – RPAs may be operated in reliance on 28(e), provided that all other applicable conditions of 28(e) are met
  - SIFMA – **partial** relief from investment adviser status for broker-dealers that receive hard dollars for research, but only when the paying manager is **required, directly or by contract** to pay for research out of its P&L or an RPA
  - ICI – advisers that block trades, but do not allocate **research** costs *pro rata*, may continue to rely on SMC Capital, but only if the adviser is subject to MiFID II (directly or by contract)
- Coordinated release of updated European Commission Q&As (also commodity position limits)

CASE STUDY #1 – U.S. MANAGER WITH EU SUBSIDIARY

- If the EU subsidiary is MiFID-licensed, MiFID II will apply fully to EU subsidiary
  - EU clients
  - US clients (direct or sub-advisory)
- Trading and Research
  - Ringfence US and EU portfolio management
  - Sharing research with affiliates
    - Equity trading with intercompany charges
    - Credit trading

CASE STUDY #2 – U.S. MANAGER WITH EU PARENT COMPANY

- MiFID II compliance does not (necessarily) extend "down" to the U.S. subsidiary
- But consider impacts on:
  - Global trade desk
  - Shared research
  - U.S. manager acting as a delegate
- Solicitation of clients on behalf of U.S. subsidiaries

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CASE STUDY – U.S. MANAGER AS A DELEGATE TO MIFID-LICENSED FIRM

- MiFID II may apply indirectly
- Scope of compliance determined by the delegating firm
- FCA letter to AIMA and the concept of “substantively equivalent outcomes”
  - Research budget
  - Valuation of research
  - Systems and controls to mitigate conflicts of interest
- Other jurisdictions

U.S. MUTUAL FUND BOARD CONSIDERATIONS

- Assess the impact of MiFID II on trading costs and reporting of soft dollar commissions on an unbundled basis
  - Free rider considerations
- Due diligence and review of sub-advisers
  - Initial questionnaire
  - Follow-up review

BREXIT UPDATE

HOW DOES THE UK EXIT?

- Article 50 of the Lisbon Treaty
- UK Two-Year Notification Provided March 29, 2017
- Two major components:
  - Withdrawal agreement (the terms under which the UK will exit)
  - New UK-EU treaty (the terms governing the relationship post-withdrawal)
- Talks are currently taking place on three aspects of how Brexit will work, focusing on:
  - on how much the UK owes the EU – reported settlement reached November 2017, totaling GBP 44-55 billion
  - what happens to the Northern Ireland border, and
  - what happens to UK citizens living elsewhere in the EU and EU citizens living in the UK.
- The UK wants to talk about future trade relations - and a plan for a two year "transition" period to smooth the way to post-Brexit relations. But the EU says they will not talk about the future until enough progress has been made on the other issues.

ARTICLE 50 PROCESS

- Art 50 of the Treaty on European Union.
- Notification in the hands of the UK.
  - UK Supreme Court required Act of Parliament
- <u>Up to</u> two-year period for **<u>withdrawal</u>** to be negotiated and take effect.
- Negotiations between the UK and the European Commission, as EU negotiator, based on guidelines issued by the European Council and in accordance with article 218(3) of the Treaty on the Functioning of the European Union (TFEU).
- Can be extended by agreement of **<u>all</u>** EU member states.
- If no extension, UK automatically ceases to be a member of the EU at the end of two years.

How Could the UK's Relationship With the EU Change?

The UK already opts out from parts of the EU. If it leaves, its future could look like Norway, Switzerland, or Turkey, nonmembers with partial participation in the EU.

● FULL PARTICIPATION
○ PARTIAL PARTICIPATION
Indicates a negotiated special arrangement.

	SINGLE MARKET	FREE MOVEMENT OF PEOPLE	CONTRIBUTE TO EU BUDGET	VOTE ON EU LAW	EUROZONE	"EVER CLOSER UNION"
STANDARD EU*	●	●	●	●	●	●
CURRENT UK MEMBERSHIP	●	●	○	●		
POTENTIAL POST-BREXIT SCENARIOS						
EUROPEAN ECONOMIC AREA (NORWAY)	○	●	○			
BILATERAL DEAL (SWITZERLAND)	○	●				
CUSTOMS UNION (TURKEY)	○					

*Except for the UK Sources: UK Government, *The Economist* Credits: James McBride, David Foster

COUNCIL on FOREIGN RELATIONS

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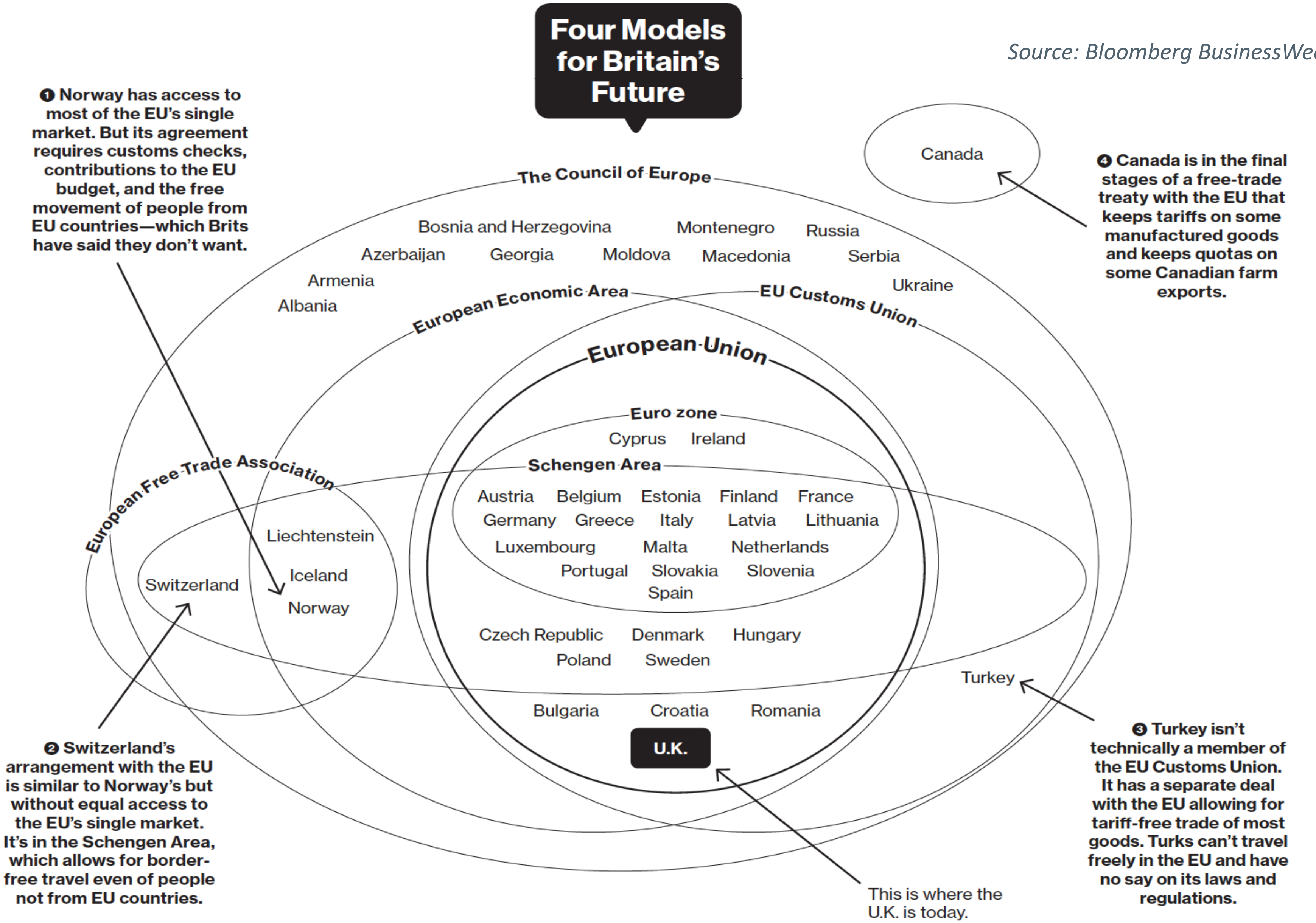

Source: Bloomberg BusinessWeek

IMPACT OF BREXIT ON FUNDS AND MANAGERS

- UCITS/AIFMs
- Cross-border advisory/management services (MiFid services)
- Solvency II, CRD, myriad of other EU laws and directives incorporated into UK laws (competition, immigration,etc.)
- Potential outcomes
  - EEA (Norway) – Single-market access for goods and services
  - EFTA (Switzerland) – Single-market access – goods only
  - Something else?

EXAMPLES

- US or EU manager has Irish ManCo with Ireland-domiciled UCITS passported into UK
- US or EU manager with UK-based UCITS for local market and passported throughout EU
- US or EU manager with UK-based UCITS for local UK market
  - *UK Non-UCITS Retail Scheme (NURS)?*

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DERIVATIVES REGULATION

- No significant changes in regulatory structure of derivatives market in immediate future
- Implications post-Brexit depend on the exit model agreed upon by UK and EU authorities at the end of the exit negotiation period
  - Will EU entities subject to the clearing obligation under EMIR be able to clear through UK central counterparties?
- The EU may consider the UK a “third country” for purposes of EMIR
  - Without a general equivalence decision, UK-based TRs and CCPs must apply for recognition from ESMA to continue to provide services to EU counterparties
  - Despite existing EMIR-compliance, obtaining recognition may take longer than expected
  - UK banks, currently clearing members of an EU CCP, might fail to meet their EU CCPs’ eligibility criteria

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IMPACT ON ISDA DOCUMENTATION

- Article 55 Re-papering exercise would be substantial
- Resolution Stay Modular Protocols matching UK and EU counterparties may be needed
- Some good news: Brexit is unlikely to trigger a standard event of default or early termination event
- Brexit could result in the early termination event if specific termination events built into an agreement relate to the investment manager of a transacting entity losing the right to do business in a relevant jurisdiction

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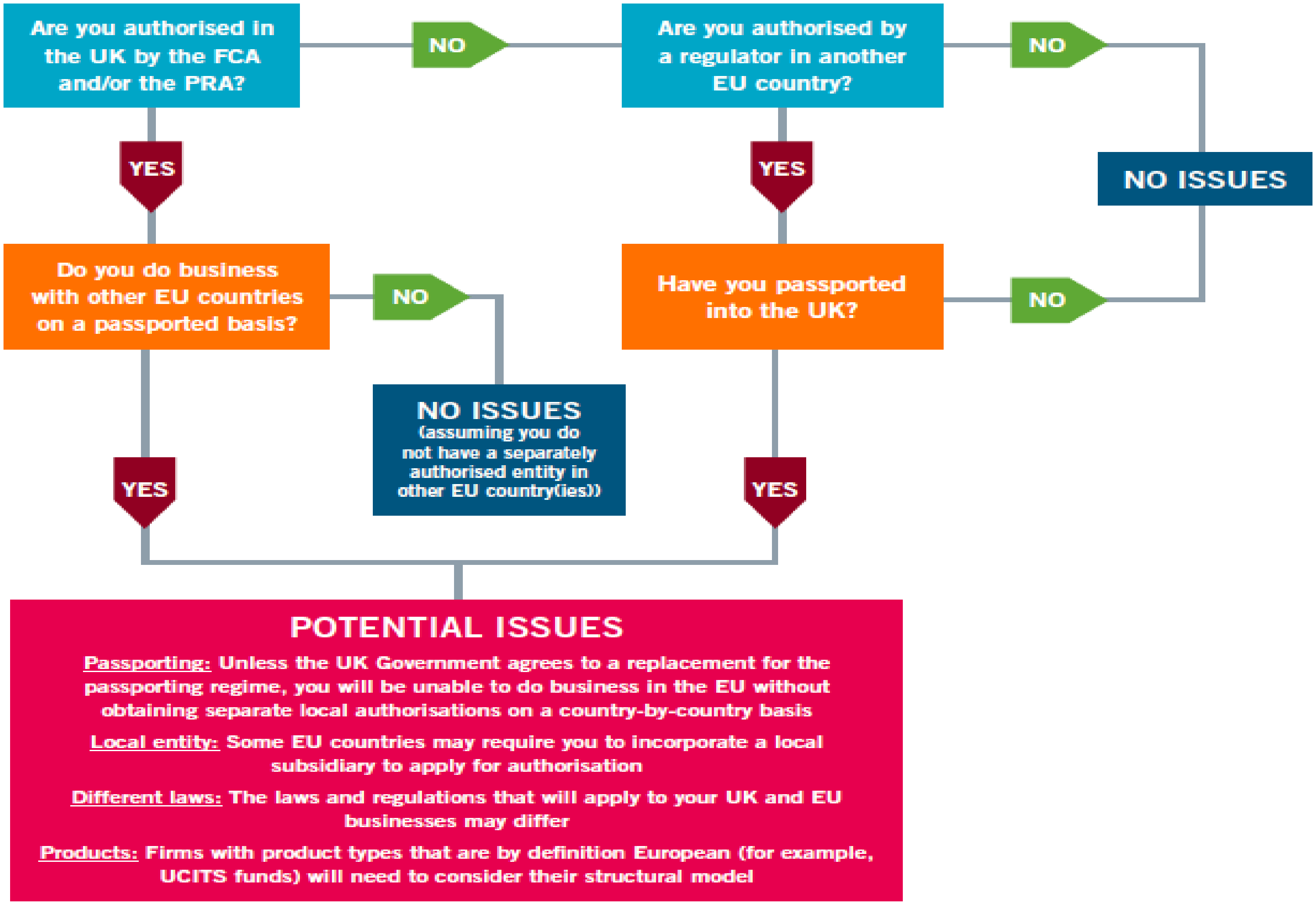
Preparing for Brexit: Implications and Issues for Firms in the Financial Services Sector



Questions?